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1. INTRODUCTION

The completion of the North American Free Trade Agreement (NAFTA) negotiations more than a decade ago was an historic event. It represented the first reciprocal free trade treaty among two industrialized countries and a developing one that was based on principles of equality and full reciprocity, in spite of vast asymmetries (the size of the Mexican economy is just 5% of the United States). NAFTA created the second largest free trade area in the world, with almost 400 million people and a third of world GDP (around US$8 trillion) and was negotiated as a way to encourage foreign investment in the member countries, especially direct investment (in plant and equipment) and to further the integration of the three North American countries through changes in institutions to facilitate cooperation and to expedite dispute resolution. The NAFTA also included supplemental cooperation agreements to enhance and encourage protection of the environment and to improve and enforce labor standards in the region

As a free trade area, the NAFTA project was essentially complete by the beginning of 2005. Virtually all tariffs and quotas -- outside of agriculture – have been eliminated. Investment restrictions have been liberalized in Canada and Mexico. Only the core of the Mexican energy sector remains off-limits to foreign investors. The current crop of major trade disputes should be resolved in the next few years – softwood lumber (pitting the United States against Canada), trucking (pitting the United States against Mexico) and sugar and High Fructuose Corn Sirup (pitting Mexico against the United States and vice versa, respectively).

NAFTA, without a doubt, has been a commercial and investment success but that does not mean that everyone in North America has prospered. Mexicans, in particular, were devastated by the peso crisis of 1994/95, and many Mexicans have seen no increase in their real wages in over a decade. To make matter worse, political elites in Mexico have been unable to agree on important reforms that are desperately needed in order to address structural problems of the Mexican economy. Canadians have on average done much better, but Canadian prosperity in the 1990s lagged by comparison with the "new economy" boom that swept the United States in the 1990`s, although this situation has changed with the burst of the dot.com bubble and especially after September 11, 2001 and the Irak war. Trade agreements, however, cannot be held responsible for all manner of financial and structural shortcomings that slow down (or even reverse) economic progress. Within a narrow commercial sphere, NAFTA has succeeded beyond the expectations of its advocates.

On the other hand, the attacks of September 11 added a new dimension to the NAFTA project. If economic borders had largely been dismantled under the banner of free trade, security borders suddenly became more sensitive after September 11th. NAFTA countries as a result have negotiated new agreements on "smart borders" whose aim is to secure the borders while keeping them open to legitimate commerce and the Security and Prosperity Partnership of North America (SPPNA) to address a further set of policies that stand in the way of more beneficial trade and investment flows, like cumbersome rules of origin, complex antidumping procedures, burdensome regulatory requirements, and other restrictive measures. In this paper, however, I will suggest additional dimensions which will have to be addressed to satisfy the twin goals of furthering economic integration while securing the North American borders.

In the second section of this paper: *NAFTA: Commercial and Investment Success,* I recap the story of NAFTA's success and review the achievements Mexico has made, as a NAFTA member, in its original goal of economic integration. In the second section, *Commercial Success did not Benefit Everyone*, however, I highlight the limitations of NAFTA for the purpose of achieving prosperity in Mexico. In this section, I discuss how -despite the significant contributions of NAFTA to the financial recovery of Mexico and for the achievement of economic stability and growth, it has not been enough and could not be enough . While trade policy can be a powerful instrument to promote development, it cannot be the only one, nor can it be a substitute for complementary domestic policies to address structural problems. The final section, suggests ways to further economic and security integration in North America, that is, to add a plus to NAFTA.

2. NAFTA: COMMERCIAL AND INVESTMENT SUCCESS

The central purpose of the North American Free Trade Agreement (NAFTA) was to liberalize trade and investment between the three North American partners. (Mayer, 1998; Weintraub, 1997). As I will demonstrate in this section, this main goal of NAFTA has been achieved surpassing the predictions of major studies that were undertaken before the negotiations were completed.

Trade within NAFTA

Since NAFTA went into effect, trade flows between the partners have experienced substantial growth.[1] Between 1993 and 2004, Total trade among the NAFTA partners, increased at an average annual growth rate of 6,4% from $289 billion to $698 billion. (throughout the paper, all money figures are expressed in US dollars).

In the case of Mexico and the United States, two-way trade boomed at an average annual growth rate of 17 percent, tripling between 1993 and 2004, rising from $85 billion to $280 billion. Two-way trade grew from 34 percent of Mexican GDP (measured at market exchange rates) to 63 percent. Mexican products increased their share in the US import market from less than 7 percent in 1993 to 16.6 percent in 2004. Mexican exports and imports increased 291 per cent and 148 per cent, respectively with a balance favorable to Mexico since the implementation of NAFTA in 1994.

Other factors, besides NAFTA, explain part of this bilateral trade growth -- notably the strong U.S. economy in the 1990s, unilateral and multilateral trade liberalization, and the Mexican devaluation of the peso in 1994-1995. (Krueger, 1999 and Flores and de la Peña, 2005). Empirical studies, however, persuasively show that NAFTA was responsible for the *exceptionally* rapid expansion of Mexico-U.S trade. In an early study, Mexican economists Enrique Espinoza and Pedro Noyola (1997) demonstrated that the patterns of sector-by-sector trade growth could only be explained by the shape of NAFTA liberalization. More recent studies of NAFTA reach similar conclusions. Ben Goodrich (2002), for example, used panel techniques to assess the causal effect of NAFTA on North American trade. He reached the conclusion that, in all six directions, North American merchandise trade substantially increased, and often

[1] The figures are based in information retrieved from the website of the Mexican Secretary of the Economy, Statistics Canada and the U.S. Commerce Department.

doubled compared to what trade would have been in the absence of NAFTA. Goodrich also showed that trade created by NAFTA far exceeds trade diverted.

An important implication of the dynamism of bilateral trade is that there has been a shift in the value added composition of Mexican trade. In 1985, raw materials and mining products were 62.4 percent of total exports, of which the most important was crude oil. Starting in 1986, this proportion starts decreasing until finally in 1993 reached a level of 19.6 percent of which oil meant 14.2 percent. At the same time, manufacturing exports grew every year from 1986 to 2004, growth which surpassed every year the growth of GNP of manufacturing domestic output all of which meant that manufacturing exports became the engine of growth of domestic output. The evolution of manufacturing exports also clearly have shown a trend towards the production of more complex goods in terms of its process of design, production and commercialization. As two observers have remarked: Mexico has become a: "reliable exporter of sophisticated products, from auto brake systems to laptop computers . . . increasingly Mexican engineers are designing products and testing them in multimillion dollar research and development centers". (Smith and Malkin 1998)

Additionally, the impact of export activity on regional development has been particularly significant because it has become geographically dispersed. In the past, Mexico's export operations were concentrated in major cities like Mexico City, Guadalajara and Monterrey, and the northern border area. Today, almost all of the 31 Mexican states, including rural states like Aguascalientes, Campeche, Durango, and Yucatan participate in international trade.

At the level of local government participation, state authorities have become aware of the potential benefits that exports can bring to their states and have acted to encourage exports and attract investment. For example, the state of Guanajuato, a major producer of apparel and footware, has opened trade offices in cities like Chicago, Dallas, Los Angeles and New York as well as in London and Tokyo. In 1995, Guanajuato had 362 exporting firms. By the end of 1998, this number had reached 768. More than 15 Mexican states have representation trade offices abroad, mostly in the U.S. For example, the states of Campeche, Tabasco and Yucatan have each opened trade offices in the state of Florida and Jalisco has established close trade links with the states of Idaho, Oregon and Washington. Trade has opened to subnational authorities new opportunities for bringing more national and foreign resources into their specific regions and has become an instrument for the promotion of each state's development agenda.

Mexico-Canada trade has also increased under NAFTA, despite the geographic distance and limited historic ties.

In 2004, 11 years after implementation of NAFTA, Canada-Mexico two-way trade reached $8 billion, up from $4 billion in 1993. Canada has become Mexico's fifth trading partner and the second most important market for its exports. While bilateral trade numbers are small when compared to bilateral trade with the United States, the Canada-Mexico trade link has the potential for sharp expansion.

Foreign Direct Investment

NAFTA is also an investment agreement, aimed at facilitating both foreign direct investment (FDI) and portfolio investment. In this area NAFTA has had also a very dramatic impact, especially in attracting substantial amounts of FDI from NAFTA partners to Mexico, as compared to previous periods. FDI was an average of $4.6 bn per year during 1989-94, almost trebled to $11.8 bn during 1996-2000, reached a peak of $27.7 bn in 2001 and came down to an average of 14.6 bn in 2002-2004. This growth in intra-regional FDI occurred in tandem with a tremendous expansion of intra-regional trade. The obvious and well-known conclusion is that NAFTA accelerated the rationalization of North American production facilities,

The connection between trade liberalization and investment growth is illustrated by three sectors where commercial ties have been most extensive: the automotive industry, textiles and clothing, and the electronics industry. In these three sectors, deeper integration is clearly evident between the three economies. Canadian, Mexican and US firms have relocated their production facilities and repositioned their supply patterns throughout the region, and they have used mergers and acquisitions across North America to strengthen their competitive stance. The reward has been higher productivity generally and a new role for Mexico

Table 1. Mexican Successful Sectors in NAFTA

Sectors	Average Annual Growth of Mex. Exports	% part. in U.S. imports 1993-2003	New Jobs
Electronic Products	19.0	10.1%-18.1%	110 000
Automotive products (Including Auto-parts)	14.8	7.1%-14.0%	200 000
Textile and clothing	19.1	4.4%-10.6%	260 000
Food, drinks and tobacco	16.7	4.3%-8.1%	100 000

Source: Secretaria de Economía del gobierno de México particularly. Within Mexico, NAFTA has encouraged more sophisticated automotive, textile and clothing, and electronic products -- going beyond mere assembly -- with significant research and development work now conducted in Mexico. These sectors have also been important generators of well paid jobs. Table 1 shows the high rate of increase in Mexican exports in these sectors, their deep penetration of the US import market (which doubled in ten years) and the high proportion of jobs generated.

3. COMMERCIAL AND INVESTMENT SUCCESS DID NOT BENEFIT EVERYONE

While NAFTA has been a commercial and investment success, it did not, and could not, bring universal prosperity to Mexico. Mexico experienced, in 1994-1995, one of its worst economic crises since the great Depression. This crisis cannot be blamed on NAFTA, but rather on a combination of adverse political factors, unsound financial practices, and mismanaged monetary policy. (Naim and Edwards 1997). From the perspective of this paper, however, the important observation is that recovery from the peso crash of 1994-95 was remarkably fast compared to recovery from the debt default and devaluation episode beginning in 1982. The difference can largely be attributed to the existence of NAFTA.

In 1982, Mexico's immediate response to the debt crisis was to drastically slash imports, building a protective fortress through stringent import quotas and prohibitive tariffs. Mexican imports fell by more than 50 percent, from $24 billion in 1981 to only $9 billion in 1983. It took Mexico seven years to get back to pre-crisis import levels. After the 1994-1995 peso crisis, by contrast, Mexico's membership in NAFTA did two things: it fostered a quick and ample financial rescue package, led by President Clinton; and it guaranteed continuity of Mexico's trade policy, led by President Zedillo. Mexico actually accelerated its liberalization program, and pre-crisis import levels were restored in around 18 months. (WTO, 1997)

Another revealing indicator is industrial production. After the 1982 debt crisis, it took Mexico about 9 years to get back to its pre-crisis level of industrial output; in contrast, after the 1994-1995 crash, it took Mexico less than two years to recover 1994 output levels (Heath, 1998). Mexican employment declined by more than 4 percent in 1995, but between August 1995 and August 2001, the Mexican economy generated 2 million new jobs. Around a million of these were related directly or indirectly to export activity.

In 2001, the combination of the US recession and a strong peso exchange rate led some multinational firms in manufacturing to close down operations for the first time in many years, blaming high labor costs. This trend continued in 2002 and 2003 but stopped in 2004 and the economy has begun recovering and generating new jobs.

In terms of wages, however, while export growth has exerted a positive impact, the majority of Mexican workers have not seen an increase in real wages in over a decade. Fortunately, better times could be ahead on the Mexican wage front. Employment as a percentage of the labor force rose from 84 percent in 1993 to 95 percent in 2004. Meanwhile, the percentage of the workforce engaged in agriculture dropped from 28 percent to 17 percent (OECD 2001). Tighter labor markets in urban areas could point to higher real wages in the next decade.

To conclude the commercial story: NAFTA has boosted North American trade and investment to a remarkable extent. Trade liberalization played a major role in Mexico's rapid recovery after the financial crisis of 1995. When the peso crashed, the Mexican economy went through a recession deeper than that caused by the 1982 debt crisis. However, in the aftermath of the 1995 financial collapse, recovery was far more rapid than expected. Trade was central to this performance. Given the collapse of the domestic market, the external market became the main engine for economic dynamism. GDP contracted 6.2 percent in 1995, however, if exports had remained stagnant, the free fall of the economy could have reached a –11 percent according to the Mexican Central Bank. Between 1994 and 1995, exports grew by 30 percent, most going to the U.S. and allowed Mexico to get back on track to recovery.

Export activity currently accounts for half of Mexico's GDP growth and almost one third of its overall GDP. In 2004, Mexico's GDP surpassed US$675 billion while Mexico's total exports reached US$160 billion. Mexico has become the eighth largest trading nation in the world and the first in Latin America. The bulk of these exports are manufactured products, which represent more than 85% of Mexico's total exports.

Yet, Mexico faced economic difficulties in the 1990s and is experiencing slow growth at the present time as a result of the US recession of 2000-2002 and especially for lack of significant structural reforms for which consensus has not been forthcoming among major political parties.

A NAFTA Plus

Mexico faces important challenges that must be addressed in the near future and for that purpose it requires to recover sustained and robust economic growth. Mexico must grow at a level of 6 to 7 percent in order to prevent further unemployment. This rapid growth will have to be financed by increased exports and a higher rate of domestic savings. Given the role that North American markets, in particular the U.S., play for the Mexican economy and especially Mexican industry , Mexican exports will have to maintain, increase and solidify their presence in the Canadian and U.S. markets.

Clearly, this goal represents a significant challenge especially now that Mexican exports are being displaced from important sectors of the US and Canadian market by more competitive Chinese products and more importantly now that assured access to the U.S. market is not certain given the security concerns that became prevalent in the U.S. by the events of September 11th, 2001. In effect, the attacks of September 11 added a new dimension to the NAFTA project. If economic borders had largely been dismantled under the banner of free trade, security borders suddenly became more sensitive. On September 11th, the U.S. adopted a series of measures at its borders north and south like the adoption of a high level alert of sustained and intense inspection which provoked a disruption of commercial traffic lasting for several weeks with a concomitant crisis for just-in-time manufacturers, particularly auto companies, and a plunging of cross-border retail shopping and tourism. This level of alert was reintroduced just before the U.S. started the invasion of Irak provoking a similar disruption of cross border trade flows.

In order to prevent future disruption of cross-border trade the three countries have negotiated new agreements on "smart borders" which aim: to secure the infrastructure and the flow of people and goods at the North American borders. (U.S. Department of State. "Smart Border…(2002) More recently, the three countries negotiated an agreement called the Prosperity Partnership of North America (SPPNA) aimed at getting rid of a set of policies and measures that stand in the way of more beneficial trade and investment flows like cumbersome rules of origin, complex antidumping procedures, burdensome regulatory requirements, and other restrictive measures.

All of these are sensible beginning measures to secure an open border for legitimate goods and services and to further the facilitation of trade. However, in my opinion, in order for the three countries to really achieve the deepening of North American integration, and prevent a worst case scenario in the security front they will have to adopt an ambitious project which could be called NAFTA Plus to address not only border and supply line inspections and trade facilitation but also further and more ambitious cooperative polices in border management and three other fronts, namely, in the elimination of external trade barrier and in the areas of defense and in migration.[2]

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[2] Under a worse case scenario like an attack by a trained terrorist armed with biological or nuclear weapons, slipping into the United States from Tijuana or Vancouver, or grain contaminated with natural or man-made biohazards was shipped from the United States to Canada or Mexico new security barriers could prove every bit as daunting to trade and investment flows as the tariffs and quotas that were negotiated away under NAFTA.

In here, I will offer some ideas of what kind of new policies would be needed in the areas of border management and external trade barriers to achieve deeper integration in North America.

Border Management

The whole point of NAFTA is to eliminate economic barriers – tariffs and quotas – at the two borders. Apart from agricultural trade between Canada and its partners, and a handful of sensitive products in U.S.-Mexico trade, economic barriers have largely disappeared. Until September 11th the purpose of border inspections was to ferret out contraband (especially drugs), and provide security against dangerous merchandise. The attacks of September 11th have added a new concern, namely, what we can call a worst case scenario, like an attack by a trained terrorist armed with biological or nuclear weapons, slipping into the United States from Tijuana or Vancouver, or grain contaminated with natural or man-made biohazards shipped from the United States to Canada or Mexico.

We have mentioned that in order to prevent this scenario the three countries have negotiated the "smart border accords" and these have made some progress to date. For instance, they have created the FAST Programs to permit the rapid and secure passage of legitimate commerce through the North American Borders. However, so far only a minimum proportion of North American firms have registered into this program.

In our opinion, however, is that in order to prevent a worst case scenario and really improve border management is to move security inspections back from the border, to the plants where shipments originate, and to ensure continuous surveillance from origination to destination. NAFTA partners have already taken the first step in addressing agricultural sanitary standards – relocating inspection and certification activity away from the border to farms and plants where agricultural produce is grown or processed. U.S. meat inspectors routinely visit Canadian packing plants; U.S. agricultural inspectors are posted at Mexican avocado orchards. The payoff is a faster trip across the border – plus better compliance with standards. After all, it's harder to inspect a packed and refrigerated container truck than an open field or processing plant.

What has already been accomplished in agriculture, should be implemented in

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other segments of merchandise trade. This will require a host of low-tech and high-tech innovations: audited security built into production lines, akin to ISO 9000; sealed and tamper-proof containers; continuous tracking of containers (using GPS) from origin to border to destination.[3]

The United States and Canada have made a start with a pilot program to inspect, at the Canadian port of entry, shipping containers destined for the United States that arrive from Europe at Halifax and from Asia at Vancouver. This is only a start, since the pilot program does not address the far larger volume of traffic originating in U.S., Canadian, or Mexican plants. Yet the technology exists for inspection and surveillance from point of origin to point of destination. While it may be costly to implement, especially for small firms, the bigger obstacle is gaining political assent, from each North American partner, for intrusive practices that entail the presence of foreign customs officials. Until that assent is forthcoming, and new systems are put in place, NAFTA's future will be clouded by periodic episodes of border strangulation, as happened after September 11.

External Trade Barriers

In the area of external trade barriers, normally when conversation turns to deeper economic integration – going beyond a free trade area – the approach that springs to mind is a customs union with a common external tariff (CET). That approach was pioneered by the Treaty of Rome (1957) for the European Economic Community, and copied for numerous economic unions since then. While a CET has many attractions and despite the fact that there has been increased talk of transforming NAFTA into a Customs Union, in my opinion, there is not at the present time a situation where the three countries could agree on a formula for choosing tariff rates for a CET. Equally difficult would be the problem of coordinating NAFTA tariff offers in the context of WTO, FTAA, or bilateral trade negotiations. None of the NAFTA members would want to concede its own freedom of maneuver to the prior approval of its partners. Even less acceptable would be delegation of negotiating authority to a supranational body, modeled after DG-1 in the European Commission.

It should be possible, nonetheless, to achieve many of the practical benefits of a common external tariff. The NAFTA partners could set a long-term goal of reducing their respective MFN tariffs to the lowest MFN level applied by Mexico, Canada or the United States, while each NAFTA

[3] A more detailed discussion of how this can be accomplished is provided in Hufbauer, Gary and Gustavo Vega-Cánovas, (2003).

partner would retain complete freedom to negotiate its rates in the WTO, the FTAA and bilaterally. Rules of origin would be waived for tariff-free trade *within* NAFTA, provided that the exporting country did not import a significant quantity of the affected inputs at tariff rates more than (say) one percentage point lower than the MFN rates applied by the importing country. The waiver procedure could be invoked on an annual basis by each importing firm.

As a package, these reforms would not add up to a customs union. There would be no attempt to harmonize quotas. Individual NAFTA partners could still invoke antidumping and countervailing duties. External MFN tariff schedules would converge only gradually. Rules of origin would linger for many years. Nevertheless, from the vantage point of firms investing and trading within North America, these changes would go far towards eradicating the residual *commercial* borders that still separate Canada, the United States and Mexico.[4]

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[4] A more detailed discussion of how this can be accomplished is provided in Hufbauer, Gary and Gustavo Vega-Cánovas, (2003).

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